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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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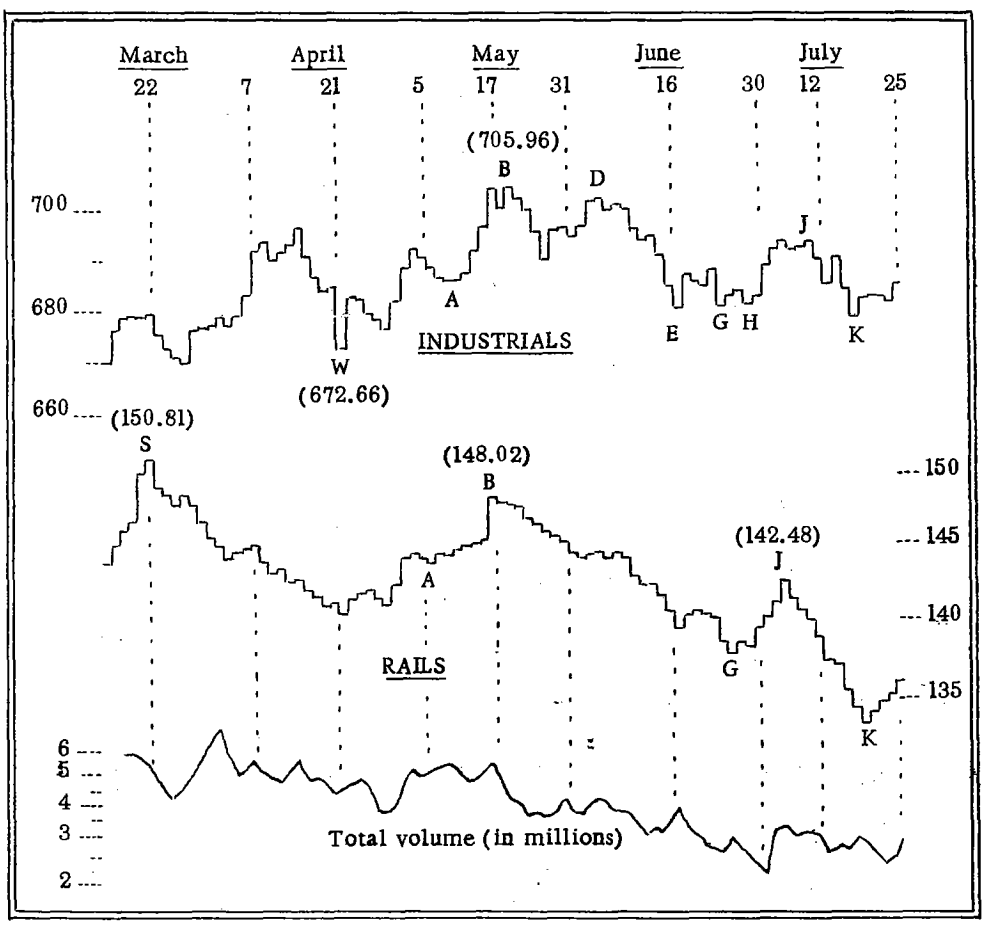
THE MARKET Letter 150 contained a chart illustrating the broad deterioration which has taken place in the "breadth" (advance-decline ratio) since May 17, 1961. From the mid-May peak to the July 18 low, the advance-decline ratio lost 33% of its entire 1960-61 gain. This means that the majority of stocks on the "Big Board" have suffered extensive corrections over the last three months.

In the face of this broad market weakness, the performance of the Industrial Average has been remarkable. Since the May 19 high of 705.96 (B), Industrials have given up only 18% of their 1960-61 gains. This fact is the more striking when we realize that between March 22 and July 19, the Rail Average erased 74% of its 1960-61 gains.

The question is asked: "Could we be in a bear market?" Rhea once wrote: "Neither I nor any man can possibly know, with certainty, the primary direction of the market when the Averages are backing and filling in an area between the primary high point and a secondary low point." For the record, we have been in such an area since March 22, when the two Averages established their last confirmed high points.

Nevertheless, clues as to the primary direction can sometimes be gathered by examining what the market has not done. In the great majority of instances, once a primary bull market has recorded its ultimate peak, stocks fall away in no uncertain manner. This "crumbling" bear market action occurred following the tops of 1937, 1939, and 1946. It did not occur at the "baby bull market" peak of 1948, and in the latter instance the Industrial Average simply sank slowly lower until it reached the vicinity of the preceding 1947 lows.



If we are still in a bull market, obviously new highs will eventually be seen. This means that there

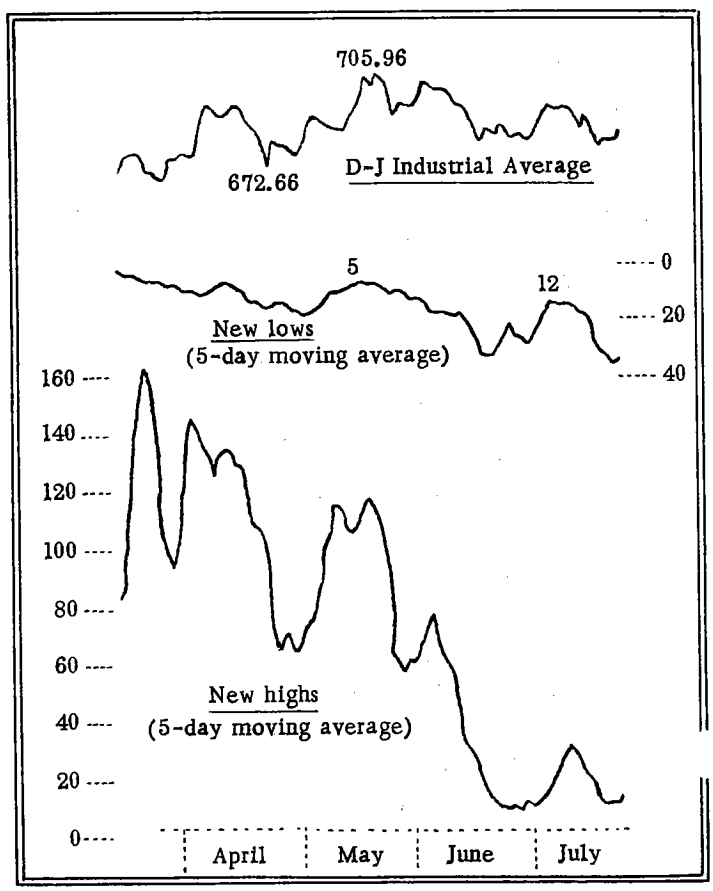
will have to be a period (normally of at least three or four months) during which the economic and political atmosphere clears. Such periods must necessarily be "rosy" enough to cause the public to buy and buy heavily (as large investment interests distribute). Thus, from the bullish standpoint the hopeful indications are (1) the remarkable resistance of the Industrial Average to anything resembling a drastic decline, (2) the continued absence of real liquidating pressure (downside volume).

From the bearish standpoint (1) the Rail action has been notably poor since March 22 of this year, (2) the Industrial formation appears "toppy" with declining peaks occurring at points B, D and J, and (3) the advance-decline ratio has been sinking lower since May 17, 1961. If Industrials go to a new high, neither Rails nor the advance-decline ratio will be in a position to confirm.

Recently, the market seemed to have reached a state of equilibrium. Over the past month cross-currents of adverse international news and hopeful domestic news have buffeted the market almost daily. Volume and price movements drew closer and closer to a standstill. Only time will tell whether the action of July 25 and 26 represented the beginning of a new and needed impulse. Since the timing of that rally corresponded to the delivery of the President's speech, however, it is well to remember that the market's first reaction to news is usually counter to the direction that it will shortly take.

CONCLUSION: The primary trend is bullish. The secondary trend is bearish, but I would consider an Industrial bettering of J (694.27) and a Rail bettering of J (142.48) as a reversal of the secondary trend. Conversely, if the Industrial Average turns down and violates the 672.66 (W) level on heavy volume, the implications will be bearish enough to justify the "cleaning out" of all equity positions.

The advance-decline ratio continues to act sluggishly when the Industrial Average rallies. This suggests (1) that the majority of stocks have seen their highs, (2) that any trading purchases should be confined to the stronger stocks in the Industrial Average. The best acting stocks in the Average are Allied Chemical, Amer. Can, DuPont, Goodyear, Amer. Tobacco, Int. Nickle, Sears-Roebuck, and United Aircraft.



NEW HIGHS AND LOWS One of the first hints that the 1960-61 advance was running into trouble was the "topping out" of the index of daily "new highs". Letter 146 (June 9) included a chart of the new high index, and it was evident from the chart that new highs were diminishing with each successive market rally. This meant that on each approach to the 705.96 Industrial peak, fewer and fewer stocks were "breaking out" of their established pattern (turning bullish). Obviously, such action suggested that the market was losing its upward momentum.

Conversely, when, on a decline, there is a steady expansion in the number of new lows, the implication is that downside momentum is increasing (as more and more stocks turn bearish). Letter 148 (June 28) examined the "new low" side of the coin. That Letter drew attention to the fact that on June 19, the five-day average of new lows expanded to 32, the largest number of new lows on that indicator since December 9, 1960.

On the subsequent mid-June to mid-July rally the new low index contracted to 12 (as compared to 5 in mid-May -- see chart). Following the rally, new lows increased as the market retreated to "test" the 680.69 level again. On July 21 the index of new lows expanded to 35, a high for 1961.

Rallies and declines in "secondary territory" (between the bull market highs and the secondary lows) can be extremely deceptive. One of the best ways of gauging the quality of such rallies and declines is to compare the level of the new high and low index with previous levels as the market movement progresses.

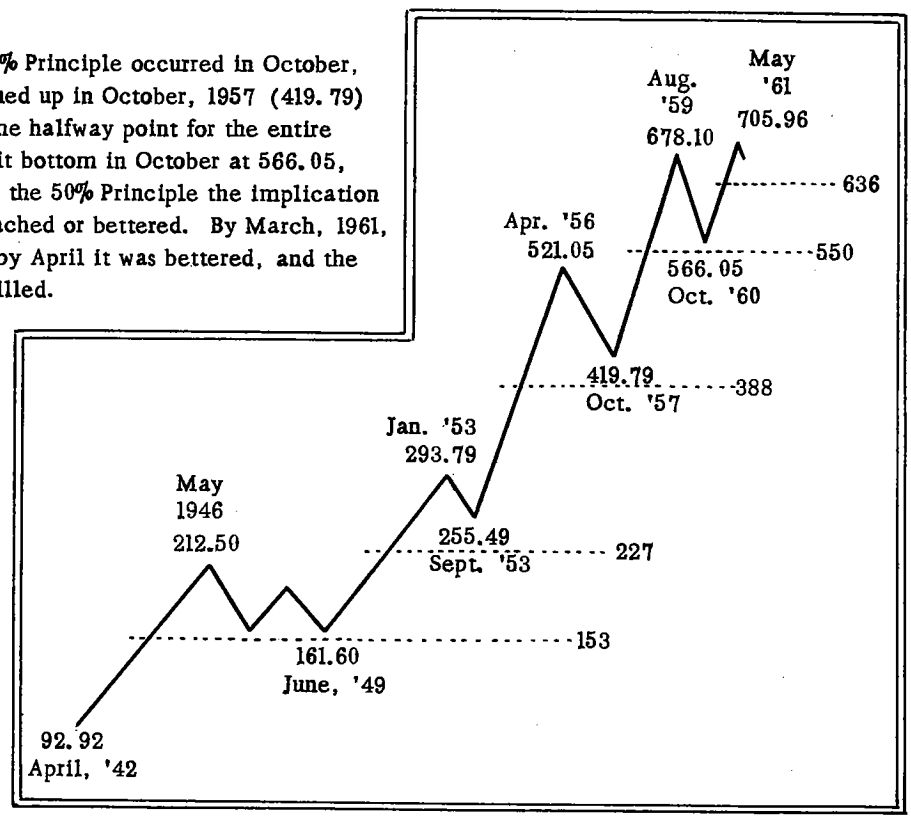
DOW'S 50% PRINCIPLE Last fall subscribers were mailed a special study containing my interpretations of Dow's 50% Principle. From his studies of the movements of both Individual stocks and the Averages, Dow concluded: (1) Following an extended advance, if the subsequent retracement holds above the halfway or 50% level of that advance, then the upward momentum has not been spent, and it is reasonable to expect a renewed advance to or above the previous highs. (2) Following an extended decline, if the subsequent rally falls short of the halfway mark of that decline, then the downward force has not been spent, and the odds favor another downward move to or below the old low.

It is an amazing fact that since April, 1942, the correction (bear market or secondary) of every major upward movement has held above the halfway level of that upward movement. The accompanying chart shows all the major advances since 1942 with the price of the Industrial Average at the beginning and end of each rise. The dotted lines represent the halfway (50%) levels of each major advance.

The most recent example of the validity of the 50% Principle occurred in October, 1960 (see Letter 130). The Industrial Average turned up in October, 1957 (419.79) and rose to a peak of 685.47 in January, 1960. The halfway point for the entire 1957-60 rise occurred at 550. The 1960 decline hit bottom in October at 566.05, just 16 points above the critical 550 level. Under the 50% Principle the implication was that the previous high would be closely approached or bettered. By March, 1961, the January, 1960 high (685.47) was approached, by April it was bettered, and the "prediction" of the 50% Principle was thereby fulfilled.

If the advance from October, 1960 (566.05) is taken as a new upward movement, then the halfway point of that advance (taking 705.96 as the high) is 636. Therefore, if any forthcoming decline breaks the 636 level, it is reasonable to assume that 566.05 will be closely approached or violated. Conversely, if any decline refuses to violate the 636 level, the odds favor another approach to or above the 705.96 high.

If we accept the advance from October, 1957 (419.79) to May, 1961 (705.96) as one continuing rise, then the halfway point of the entire advance is 562. The 562 level is so near the October, 1960 low of 566.05 that for obvious reasons I would rather use the latter figure.



Therefore, we can say that if a decline breaks first 636 and then 566, the odds will favor the 419.79 low being closely approached or violated. Conversely, if a forthcoming decline can consolidate and hold above 566, then in time we should witness another try for the 705.96 high.

As explained earlier, all declines since 1942 have held above the 50% level of the preceding major advance. Consequently if 636 and then 566 are violated, it will be the first time since the 1930's that such an event has occurred. This would call for a more drastic downward move than anything seen since the 1937-38 bear market.

STOCKS Nine of the seventeen Dow stocks in our "continuing study" group are now under their long-term (30-week) moving average.

In the last Letter I mentioned that General Motors (considered by many analysts to be the most important single stock on the "Board") was right on the edge of its moving average (M. A.). Following the sharp drop from its May high of 49 1/2, GM dropped to its M. A., then held above or on its M. A. for seven weeks. Last week GM began its first rally since May, and the stock remains in a bullish trend (I have classified GM as bullish since February). M. A. of GM is now 44 7/8.

Much the same can be said of duPont. DD turned bullish in January, 1961, has held above its M. A. (now 209) ever since. DD has recently rallied to its highest point since the May peak of 229 1/2, and I continue to classify the stock as bullish.

International Paper broke down in June and is holding below its current M. A. of 32 7/8. Perhaps the most interesting feature of IP is the fact that the short interest in the stock has been rising for four consecutive months (usually a constructive sign). I list the stock as bearish at this time.

Standard Oil of N. J. drifted under its M. A. in June. Letter 148 discussed J, and at that time I said that I would avoid the stock for both investment and trading purposes. M. A. on J is now 45 1/8, and I have not changed my opinion. I continue to list J as bearish.

Southern Pacific has held grimly above its M. A. which is now 23. Actually, SX has been outstanding in the Rail group in that it has resisted the entire decline in the carrier Average. SX would be my choice as a Rail to participate in any rally from this area.

One of the stronger looking stocks in a strong group is North American Aviation. The stock formed a "double top" in the 53 area (the first peak occurred in 1959). Since March of this year NV has traced a consolidation triangle, and a few weeks ago the stock broke to the upside. Purchases can be made here on the hopes that the current advance will carry through to new highs. (Chart of NV courtesy of Traders Research, P.O. Box 6185, Lambert Airport, Missouri)

(Written: Wednesday, July 26th - 1 P.M.)